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Macroeconomic Adjustment and Growth

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# Adjustment Programs and Bank Support

## Rationale and Main Results

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Adjustment should begin with policy and institutional reforms to deal with the ultimate causes of any macroeconomic crisis a country is experiencing. Only when progress has been made in reducing inflation and fiscal and balance of payments deficits should other structural reforms begin — of the public sector, trade and competition, the financial sector, and the labor market.

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This paper — a product of the Macroeconomic Adjustment and Growth Division, Country Economics Department — was prepared for presentation at the Conference on Policies for the Recovery of Growth: Adjustment Lending Revisited, held at the World Bank on September 13-14, 1990. It is part of a larger effort in PRE to improve the understanding of the role of policies in economic performance. When the first draft was written, Fischer was Vice President, Development Economics and Chief Economist of the World Bank. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Lu Oropesa, room N11-035, extension 39075 (36 pages).

Corbo and Fischer review the rationale for programs and then evaluate the design, implementation, and effectiveness of Bank-supported adjustment programs. Among lessons they draw from this review of the programs are the following:

• In countries experiencing acute macroeconomic imbalances (high fiscal deficits, balance of payments crises, and high open or repressed inflation), adjustment should start with policy and institutional reforms to deal with the ultimate causes of the macroeconomic crisis. Once progress has been made in reducing inflation and the fiscal and balance of payments deficits, other structural reforms aimed at improving resource allocation and achieving sustainable, equitable growth should be tried (particularly reform of the public sector, trade and domestic competition, the financial sector, and the labor market).

• The Bank can help adjustment by giving both policy advice and finance and by mobilizing other sources of finance.

• Adjustment lending has a positive effect on growth, constant-price export rates, and saving rates, and a negative effect on the investment ratio. In the short run it does not appear to affect systematically changes in living conditions.

• The implementation rate of programs increased in the 1980s, both for countries that received adjustment loans since the early 1980s and for those that started more recently. Implementation rates are lower for countries with higher rates of inflation or that suffered heavier negative external shocks. Successful stabilization and appropriate adjustment to external shocks (including contingency financing) increase the implementation rate.

• To be successful, an adjustment program must be owned by the government. External financing alone won't work. It is important to diagnose the country's development problems and to build a consensus around the adjustment program.

• Political support for stabilization is more likely when the government actively explains the source of the problems the program addresses, how it plans to tackle them, why this is the best option, and how people will benefit from the new policy environment. Awareness of the economic problems that motivate the decision for reform is strongest at the beginning — so prompt implementation usually increases the chance of political support.

• Adjustment usually calls for reducing public spending but it is important to strengthen public institutions through improved policies, organization, and management.

• The ultimate success of adjustment depends not only on getting the right policies in place but on increasing investment — including efficient public investment, saving, and growth. Public policy can contribute to these objectives by mobilizing savings and providing a macroeconomic framework that supports investment and efficient growth.



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## I. Introduction

The World Bank introduced Adjustment Lending in 1979 to assist member countries to deal with the second oil shock by providing temporary balance of payments financing while the necessary stabilization and structural adjustment measures were expected to take effect.[1] Adjustment lending -- defined as rapidly disbursing, policy-based lending[2] -- grew in importance after the onset of the debt crisis in 1982, which both reduced the availability of financing and brought growing recognition of the need for structural reforms by many Bank member countries. By the end of the 1980s adjustment lending accounted for about 25 percent of total World Bank lending, and for well over 50 percent of lending to some heavily indebted countries.

The typical country initiating an adjustment program supported by the Bank -- usually in its initial phases supported also by the International Monetary Fund -- faces pressing macroeconomic problems that are manifested in the form of a large fiscal deficit and an unsustainable balance of payments deficit, and in many cases open or repressed inflation. These problems usually stemmed from a mixture of expansionary demand policies and large external shocks to the real interest rate, commodity prices, the demand for exports, and the availability of external financing. Typically, political and institutional weaknesses limit the capacity of the country to respond to the external shocks.

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[1] For the origins of adjustment lending, see Stern (1983).

[2] Adjustment lending is sometimes also defined as balance of payments support lending; since all capital inflows support the balance of payments, the emphasis is more accurately placed on the rapidly disbursing feature.

Structural adjustment programs seek to achieve both macroeconomic stabilization and structural transformation of the economy to address the longer-term fundamental causes of the country's economic crisis. Stabilization measures to restore macroeconomic balance focus on bringing the level of demand and its composition (tradable relative to nontradable goods) in line with the level of output, and the available level of external financing. In most cases the economy requires a reduction in the fiscal deficit and the realization of a real devaluation to restore internal and external balance. The longer-term structural reforms focus both on creating more appropriate incentives -- by deregulating domestic goods markets, reforming the public sector, liberalizing the trade regime, removing constraints on factor employment and mobility, and removing obstacles to saving and investment, and on strengthening institutional elements -- including the government's capacity to implement policies and the framework for private sector development.

In countries with acute macroeconomic problems, structural reforms to increase efficiency and to restore growth, whose efficiency depends on a predictable macroeconomic situation, should be initiated only when sufficient progress has been made in reducing the macroeconomic imbalances. However, in some cases substantial reforms in the operation of public enterprises and the financial system may be needed to achieve stabilization. (Eastern Europe and Chile 1973-75 are good examples here.) This type of structural reform is undertaken concurrently with the stabilization program. The importance of this sequence of reforms -- reforms oriented mainly to reduce severe macroeconomic imbalances first and to improve resource allocation and restore growth later -- has become increasingly clear with experience. But the argument also has strong analytical underpinnings: the benefits of structural reforms that aim at improving resource allocation through changes in incentives, generally transmitted through relative price changes, are reduced by macroeconomic instability in the form of high and variable inflation and balance of payments crises (Corbo and de Melo 1987; Fischer 1986; and Sachs 1987).

Reforms undertaken as part of a Bank-supported adjustment program add to the country's indebtedness, and should not be attempted unless there is sufficient probability that they will succeed. While structural reforms to improve resource allocation initiated before stabilization can turn out to be productive,[3] the weight of the evidence suggests that reforms of this type undertaken in highly unstable macroeconomic conditions are typically unsuccessful. Reforms that start with low credibility about their sustainability may temporarily get current relative prices right, but consumers and producers perceive that the reforms will not last and intertemporal relative prices are accordingly distorted. The result is that the responses of consumers and producers can destabilize the whole reform effort (Calvo 1989). Country studies have also shown that many failures of liberalization attempts have been due to the absence or failure of accompanying stabilization efforts (Krueger, 1978 and 1984, Papageorgiou, et al., 1990 and Corbo and de Melo, 1987).

The Bank periodically evaluates the effectiveness of the adjustment programs it supports, as well as their design and implementation.[4] It also

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[3] For instance, some of the reforms undertaken before stabilization in Mexico appear to have been long-lasting.

[4] Two recent comprehensive reviews are World Bank (1988a and 1990a).

interacts with the research community and carries out a continuous research program on different aspects of the economic development problems facing developing countries. From these evaluations, its interactions with the research community, and the findings of its research program, the Bank derives lessons for the design and implementation of programs. This paper summarizes some of those findings and lessons.

## II. Stabilization Measures

Stabilization includes the restoration of external (current account) and internal (unemployment) balance, as well as the control of inflation. The success rate of stabilization programs in countries that have experienced a prolonged period of high inflation is very poor: countries typically undertake many attempts to stabilize, often showing temporary success, but longer-term success is elusive (Kiguel and Liviatan, 1988). Short-term success can be obtained by a temporary fiscal adjustment with restrictive monetary policy and/or fixing the exchange rate but longer-term success cannot be achieved without long-lasting reductions in the broadly-defined public sector deficit. In some countries, incomes policies can also play an important supporting role in stabilizing expectations, braking inflationary momentum, and increasing the political support for stabilization programs (Bruno and Piterman, 1988; Dornbusch, 1989; Kiguel and Liviatan, 1990; and, Solimano 1990). But incomes policies are useless, and may be counter-productive, if the country does not undertake the necessary fiscal adjustments.

Fiscal adjustment not only removes the underlying cause of inflation, but also helps to reduce absorption and thus decrease the non-interest current account deficit towards a level that is compatible with the sustainable level of external financing and interest payments on the external debt. A real devaluation that increases competitiveness is also a key component of the restoration of external and internal balance. If the reduction in absorption is not accompanied by a real devaluation, then the demand for both tradable and nontradable goods will be reduced. Lower demand for tradable goods contributes directly to the reduction in the non-interest current account deficit. Lower demand for nontradable goods, without a real devaluation, will reduce the output of nontradable goods, and unemployment and excess capacity will result (Corden 1981; Dornbusch 1980).

Short-Term and Structural Reforms for Stabilization.

Rapid success in stabilization usually requires a mixture of cuts in government spending (especially subsidies), reductions in public enterprise losses, the tightening of credit, and tax increases, undertaken in a given institutional setting. Frequently central bank losses, resulting from the provision of credit subsidies to particular sectors and often through the exchange rate system, are an important source of inflationary pressure, that has to be closed immediately.

Structural reforms are needed to cement the stabilization as well as lay the basis for the renewal of growth. These include tax reforms, substitution of QR's by tariffs, reduction in protection, public enterprise reforms and/or privatization aimed at reducing the non-financial public sector deficit, and changes in the financial system and the central bank's role in it. Generally these reforms need to be phased in as institutions have to be put in place and regulatory frameworks established (World Bank, 1988a). Institutional weaknessess and political factors sometimes make it difficult to carry out these structural reforms.

Bank Support for Structural Reforms in Support of Stabilization

The expectation when the World Bank begins to support an adjustment program is that the country will undertake a phased program of structural adjustments. While a first structural adjustment loan may mainly support short-term stabilization measures, also supported by the IMF, government actions envisaged under the terms of the loan typically include the early stages of some longer-term structural adjustments. Subsequent loans, often in the form of sectoral adjustment loans, will focus more on structural adjustment measures. Among these measures are tax reforms, the restructuring of public expenditures, measures to increase the efficiency or to support the privatization of state-owned enterprises, trade reforms, financial market reforms, and other sectoral reforms.

Adjustment lending facilitates the phased reduction of the current account. By providing financing to help maintain the level of expenditure, it potentially reduces the short run adjustment costs to output, employment and consumption. By providing sustained support over a period of time, the Bank hopes to give the country time needed to undertake reforms with long implementation periods. It is of course possible that the availability of additional financing merely postpones urgently needed reforms by reducing immediate pressures on the government. Loan conditionality is designed to prevent this. Analyses of adjustment lending have accordingly carefully examined implementation rates of loan conditions.

## III. Structural Reforms to Improve Resource Allocation, Increase Growth and Reduce Poverty

Once inflation has been reduced in a credible way, and progress has been achieved in reducing the non-interest current account deficit, the potential benefits of structural reforms aimed at improving resource allocation and achieving sustainable growth are increased. For each country, economic research and country-specific economic and sector work is required to identify the most important distortions that hinder the allocation of resources and limit growth. After the largest distortions have been identified, a central question is the sequence and speed of reforms. We discuss these two points in order.

### Sequencing of Reforms

In the presence of multiple distortions, the question of the optimal sequence of reforms is a difficult one because policy is working in a world of second (or higher) best. In such a situation, the welfare benefits of reforms are case specific and depend on initial conditions and interrelations across markets (Edwards, 1989; and the papers in Choksi and Papageorgieu, 1986).

Despite the popularity of the concept of sequencing, the notion is to some extent misleading.[5] Some reforms should be undertaken in simultaneous packages, rather than in strict sequence. Further, it is necessary to distinguish between the time at which decisions on reforms are taken, and the time at which they are implemented.

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[5] This argument is developed in the context of socialist economy reform by Fischer and Gelb (1990).

However, some general recommendations on the sequencing of reforms have emerged. First, reforms should start with large reductions in big distortions. Second, in economies with restrictive trade regimes, widespread price controls, and restrictive domestic competitive practices, goods market reforms should precede asset market reforms. In particular, the liberalization of the current account should precede the liberalization of the capital account. This recommendation is based on two arguments. First, the speed of adjustment in asset markets is much faster than in commodity markets and, therefore, to avoid large movements in capital flows and the real exchange rate, capital controls should limit capital flows to the rate at which goods markets adjust to domestic deregulation and foreign trade liberalization (Frenkel, 1982 and 1983). Second, because asset prices are determined by the expected present value of future income streams, distortions in goods and factor prices result in assets being traded at distorted prices; the consequence is a misallocation of investment. The potential gains from deregulation of goods markets can also be severely curtailed in countries where there are major impediments to labor mobility and domestic financial markets are almost non-existent. For such economies, reforms in the labor market and the development of a domestic financial market should accompany the goods markets reforms.

Speed of Reform

Politicians and some economists are attracted to the gradual implementation of stabilization and adjustment measures. The attraction for politicians lies in the possibility of avoiding painful measures and reducing opposition; for economists, gradual smooth adjustments appear likely to reduce the overall costs of adjustment. For instance, in considering tariff reform, the politicians will see a phased reduction in tariffs as a way of reducing the intensity of opposition from powerful domestic producer interests; economists argue that domestic producers who might in the short run be driven out of business by foreign competition can become internationally competitive given temporary but inexorably declining protection.

Gradual stabilization is unlikely to be a real option when inflation is very high and the balance of payments deficit unsustainable. Gradual reductions of inflation have rarely been achieved from inflation rates in excess of 100 percent per annum, possibly because several forces tend to push inflation higher in those conditions. Further, a severe credibility problem faces a government that promises a gradual reduction of fiscal imbalances over time, but does not implement much change at the beginning. If, as is typically the case, the country also faces a balance of payments crisis, a comprehensive and immediate stabilization package may be the only realistic and credible stabilization option.

Structural adjustment measures that require the development of institutions and appropriate human capital (e.g. financial reforms, tax reform) have to be introduced more gradually, if only because they take time to plan and implement. General economic arguments suggest that, where possible, as in the case of tariffs, distortions be removed quickly, to enable resource reallocations to take place at the right prices sooner rather than later (Mussa, 1982; Edwards, 1989). However, given market imperfections, including the possibility of bankruptcy, rapid changes in relative prices can increase adjustment costs.

Calculation of the right speed at which to introduce changes in relative prices thus requires a balancing of the greater credibility of rapid reforms against the likelihood that rapid changes increase adjustment costs.[6] Adjustment lending can help mitigate adjustment costs, and thereby sustain an adjustment effort; in addition, the conditionality in adjustment lending can increase the credibility of an adjustment program.

We conclude that while rapid stabilization is usually essential, the appropriate timing of longer-term structural reforms depends on country-specific political economy and economic conditions. Depending on country circumstances, the gradual introduction of structural reforms may be preferable to an attempt to remove all major distortions extremely rapidly (Michaely, 1987).

Sectoral Reforms

We examine four areas of sectoral reform in detail: public sector reforms, trade/domestic competition reforms, financial sector reforms, and labor market reforms. Although most reform efforts have been centered in these four areas, labor market reforms have, for political reasons, been very difficult to carry out.

1. Public Sector Reforms

Public sector reform is at the center of macroeconomic and resource allocation problems in many countries in need of adjustment. It is accordingly not surprising that public sector reforms are central components of most adjustment programs. Public sector reforms include macroeconomic reforms aimed at reducing public sector deficits and microeconomic reforms aimed at increasing the efficiency of public sector policies. Fiscal reforms to improve revenue collection, and to reduce the level and enhance the

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[6] Webb and Shariff (1990) also discuss some of the political economy aspects that affect the speed of reforms.

efficiency of public expenditures, and actions to reduce the losses of public enterprises are the typical actions included in macroeconomic reforms of the public sector. Microeconomic reforms include the reshaping of institutions, restructuring of public enterprises and/or privatization. In many countries public sector reforms also include improvements in the capacity of the public sector to provide basic primary health and education services.

2. Trade/Domestic Competition Reform

Small countries with very distorted trade regimes and non-competitive goods markets should over time obtain large benefits from reducing non-competitive practices and liberalizing trade. Although familiar, the arguments against distorted trade regimes bear repetition: they generate resource misallocation within import competing sectors, tend to repress exports, and contribute to socially unproductive rent seeking activities, and by reducing competitive pressures also tend to slow technical progress. Structural reforms in the trade area aim at reducing the average level and variance of tariff rates with the ultimate objective of moving towards a more uniform tariff structure. As a practical rule, incentives should not discriminate against export-oriented activities and should promote the development of broadly uniform across-the-board effective incentives for import competing activities (Little, Scitovsky and Scott, 1970; Corden, 1974; Balassa, 1976; Thomas et. al., 1990).

On the basis of this analysis, the Bank has supported trade reform as a central element of adjustment programs, in both structural and sectoral adjustment loans (Thomas, et. al., 1990). Bank-supported trade reforms have been phased in gradually.

Trade policy reform recommendations are derived from the standard theory of commercial policy and from the empirical work on commercial policy referred to above. It could be claimed that new developments in trade theory call into question these recommendations and provide a new foundation for differentiated tariffs and, in a more general sense, for an active industrial policy. The new trade theory holds that international markets are typically imperfectly competitive, and that trade is, to a considerable degree, driven by economies of scale rather than comparative advantage (Helpman and Krugman 1985). A policy implication of this theory is that government should favor industries that generate externalities.

The policy recommendations that seem to follow from the new trade theory -- and that are buttressed by the view that well-designed government interventions enhanced growth in East Asian countries -- have met substantial criticism on both economic and political economy grounds. On the economic side, the policy recommendations tend not to be robust to changes in model specification. On the political economy side, it has been argued that the work on rent-seeking and tariff formation clearly indicate that actual tariff structures are driven more by the pressures of interest groups than by efficiency considerations.

On the basis of such considerations, Krugman (1987, p.143) concludes that "the gains from intervention are limited by uncertainty about the appropriate policies..., by the general equilibrium effects that insure that promoting one sector diverts resources from others. ...Once the expected gains from intervention have been whittled down sufficiently, political economy [factors] can be invoked as a reason to forego intervention altogether. Free trade can serve as a simple principle with which to resist pressures of special-interest politics." Helpman (1989, p.213), while showing that the new theories have had several empirical successes in explaining trade phenomena, similarly concludes that "free trade remains a good rule of thumb". (See also Corden, 1990; Helpman and Krugman, 1989; Krugman, 1990 and Srinivasan, 1989).

3. Financial Sector Reforms

Financial sector reforms aim to improve the efficiency of intermediation and the use of resources, including the allocation of investment. The reforms attempt to reduce distortions in credit allocations, typically in part through the removal of controls on interest rates, with the intention of allowing them to become market determined. In addition, appropriate information and prudential supervision systems need to be put in place.

Initial conditions play a central role in the design and implementation of financial reforms. If a large proportion of the assets of financial institutions are held at below market rates or are non-performing, then financial reform will create difficulties for existing institutions. In particular if deposit and lending rates are deregulated simultaneously and free entry into the financial system is allowed, existing banks will be forced to pay market interest rates. They will suffer substantial losses, jeopardizing the banking system's solvency and macroeconomic stability. It may be necessary in such cases to allow for a transition phase, in which lending rates are deregulated first, with deposit rates following only gradually (World Bank, 1989). In other cases, most banks may be insolvent before the financial reforms are implemented. The banks then have to be recapitalized, thereby creating a potential fiscal problem. In countries where domestic financial systems are practically non-existent, the creation of a financial system to provide at the minimum financing for working capital should be a high priority, though not one that can be realized very rapidly. This point could be especially relevant for Eastern Europe (Calvo and Coricelli, 1990).

Financial sector reforms are among the most difficult to undertake, because the running of such institutions requires a great deal of specific business knowledge and experience. They are also difficult to evaluate, in particular because recapitalized institutions can run for some time without problems becoming evident.

4. Labor Market Reforms

Labor market regulations and institutions may play a key role in the efficiency and ultimate success of a structural adjustment problem. In countries that require a large real devaluation to accompany absorption reduction policies, obtaining an initial decline in real wages could make a major difference between a large recession with massive unemployment (Chile, 1982) or macroeconomic adjustment without a major change in unemployment (Mexico, 1983-89). Labor legislation or convention, in the form of rigid wage indexation rules, is often a major impediment to successful macroeconomic adjustment and the ultimate success of structural reforms aimed at improving resource allocation in goods markets.

Success could also be hindered by rigid labor practices that restrict labor mobility. Large severance payments, lack of flexibility in the real wage structure, the attachment to employment of substantial non-wage benefits, such as housing, utilities and education, and other institutional rigidities to labor mobility are typical impediments to successful adjustment. They need to be addressed early in structural adjustment programs, but are in practice very difficult for a government to tackle.

Promoting economic growth

Structural reforms that contribute to the reduction of macroeconomic imbalances and the improvement of resource allocation create the foundations for a recovery of growth (Fischer, 1987). Sustained growth generally has four main requirements: stable macroeconomic conditions, an appropriate incentive and resource allocation system, an adequate level of saving, and efficient institutions to turn saving into productive physical and human investment. We have already discussed some necessary elements in achieving the first two requirements.

Since most indebted countries are likely to be making net transfers abroad rather than receiving net foreign resources, they will need to make a major effort to increase national saving. The weight of the empirical evidence suggests that private saving rates are not very sensitive to policies and, in particular, to interest rates (Giovannini, 1985; Schmidt-Hebbel, et al., 1990). However, negative real interest rates probably discourage saving -- certainly they reduce the efficiency of financial intermediation -- and encourage capital flight. Private saving rates are very sensitive to the economic cycle as a result of consumption smoothing. If there are no leakages through lower private saving, public saving can contribute to an increase in national saving. Empirical evidence presented in Corbo and Schmidt-Hebbel (1990) shows that public saving can make a major contribution to an increase in national saving (see also Summers, 1985). The evidence on saving again highlights the central importance of fiscal balance.

The last factor, an increase in the rate and efficiency of private investment, is much affected by a stable macroeconomic framework and clear and predictable tax rules and property rights (Rodrik, 1989; Serven and Solimano, 1990a and 1990b).

The belief that economic policy and the investment rate are major determinants of economic growth has long been expressed in the writings of economists. However it is only very recently that models have been able to capture the links among policy, investment and long-term growth. The new endogenous growth literature, pioneered by Romer (1986, 1990) and Lucas (1988), has created a class of theoretical models in which economic policy can affect investment, human capital accumulation, technological innovation and resource allocation in ways that alter long-run, steady-state growth rates.

The ideas underlying these models -- economies of scale, externalities, and public goods -- and the argument that the removal of distortions promote growth have been familiar for a long time, and form the foundation for over three decades of World Bank programs. At a minimum, the new models provide a framework that may improve understanding of growth-promoting policies that have been suggested and implemented in the past (Easterly and Wetzel, 1989); possibly they will also improve the quality of growth-promoting policies in the future.

This literature highlights a number of channels through which public policies can affect growth. Recent World Bank papers by Arrau (1989), Romer (1989), and Rebelo (1990) show that promoting human capital accumulation, for example by providing adequate nutritional levels and basic educational skills, and investment in Research and Development, can foster growth. Along these lines, Becker, Murphy, and Tamura (1988) show that economies may become stuck in a poverty trap: a situation where low income and low human capital levels create incentives for high population growth and low investment in human capital that perpetuate the state of poverty. Policies that stimulate investment in human capital can break the economy out of this stagnant situation.

The new models also stress the importance of trade policy, fiscal policy, and financial policy, confirming earlier empirical work. The World Bank has been at the forefront of empirical studies of trade policy and growth. Along with large multicountry case studies, recent work by Feder (1983), Balassa (1985), Easterly and Wetzel (1989), de Melo and Robinson (1989), Nishimizu and Page (1990), Dollar (1990), and Levine and Renelt (1990) have carefully examined the cross-country evidence on trade policy and growth. The result of this empirical work indicates that, after adjusting for factor accumulation, countries with more open economies have had higher rates of growth.

Governments are capable of policies that enhance growth and also of policies that hinder growth. In Easterly (1990) and Barro (1990), governments may have positive growth effects by providing essential public goods; they may have negative growth effects by wasting funds on worthless projects and bloated bureaucracies, or by imposing taxes and regulations that distort saving and investment decisions. It is thus necessary to conduct a detailed study of the composition of government expenditures and the structure of taxes to evaluate the effects of any country's fiscal stance on growth. These studies find a negative effect of higher government consumption on growth. However, the complexity of the relationship between fiscal policy and growth is borne out by recent empirical work in Levine and Renelt (1990). They find that broad macroeconomic indicators of fiscal policy are not robustly related to growth in a cross-section of countries.

The role of financial policy in growth has also been the focus of World Bank scrutiny. Gelb (1989) and Easterly and Wetzel (1989) present preliminary evidence suggesting that, after controlling for factor accumulation, financial deregulation from severely distorted initial positions has a positive effect on growth.

Alleviation of poverty

The ultimate objective of Bank lending is to contribute to economic development and the eradication of poverty. Indeed, the reduction of poverty is the central objective of most Bank country assistance. The strategy to reduce poverty enunciated in the 1990 World Development Report has two components: first, to encourage broad-based economic growth and in this way to promote the use of the poor's most abundant asset -- labor; second, to improve the provision of social services to the poor -- especially primary education, social infrastructure and basic health care (World Bank, 1990b). The second component is desirable not only for its own sake, but also because it enhances the productivity of the poor. In addition the World Development Report recommends the adoption of targetted interventions to reach those, such as the old and those living in especially poor regions, who are not helped by the basic two-part strategy.

Adjustment from an unsustainable economic situation, following policy mismanagement or adverse external shocks, often has significant short run social costs. The poor, who already have low welfare levels, may find it very difficult to absorb short-term losses. Therefore, adjustment programs also include an assessment of the short-term effects of policies on the poor as well as specific measures to protect the poor during the transition (Maasland and Van der Gaag, 1990).[7]

Attention to the impact of adjustment on the poor is not only desirable in its own right, but also helps assure the sustainability of adjustment programs. While as a logical matter, the costs of adjustment should be calculated by comparing economic performance under adjustment with the likely outcome of non-adjustment, political perceptions evaluate adjustment policies by comparing the (typically unsustainable) pre-adjustment situation with the conditions following implementation of adjustment policies.

Why is World Bank Support Needed?

If reforms are as favorable as the World Bank claims, why do countries require financial support from the Bank to undertake them? The answer is that even very beneficial reforms may have important transitional adjustment (and distribution) costs that could make their implementation difficult. Balance of payments support could make an important contribution to the sustainability and ultimate success of the reforms by reducing the need to cut expenditures and imports while the reforms are being implemented. As countries are restricted from borrowing in international capital markets, Bank lending, conditional on the implementation of a program, helps sustain expenditures while the reforms are being implemented. We discuss now the rationale for balance of payments support for the different types of reform discussed above.

In the case of public sector reforms, quick disbursing balance of payment support could contribute to temporary financing of the budget deficit,

[7] Attention to the impacts of adjustment measures on the poor increased during the 1980s as it became clear that adjustment would not be effected quickly.

while structural reforms of the revenue system and of government expenditures are put in place. Since large budget deficits typically underlie current account deficits, these fiscal reforms usually also make a direct contribution to a sustainable reduction in the current account deficit.

In the case of trade reforms, balance of payment support could make an important contribution to the financing of a transitory increase in imports while the reforms take time to result in increased exports. Since people expect this difference in response times, the availability of financing could contribute also to the credibility and sustainability of the reforms. External financing can also help bridge some of the short-term adjustment costs incurred in industries that need to restructure or to disappear altogether. Similarly, reductions of distortions in goods markets that are likely to be beneficial in the long run can result in temporary unemployment of resources. The costs of this unemployment can be reduced through adjustment lending.

In the case of financial sector reforms, balance of payments support could contribute to financing transitory increases in government expenditures resulting from recapitalization of banks and the reduction in taxation of financial intermediaries.

In each case, the World Bank's financial support for adjustment programs can cushion some of the short-term adjustment costs of reforms and in this way contribute to their sustainability and ultimate success. Furthermore, to the extent that the Bank brings its expertise to bear, its lending helps member countries to design and implement more effective programs and, in this way, to adjust more successfully.

For the Bank itself, successful adjustment programs help restore a country's growth and improve its creditworthiness. Furthermore, the benefits of project lending are severely curtailed in highly distorted economies, and adjustment lending can therefore contribute to the success of project lending. Indeed, with distorted incentives, increased investment financing may increase capital accumulation in the "wrong" activities, exacerbating the misallocation of resources. In the extreme, taking into account the need to service the debt, it could even result in immiserizing investment.

## IV. Main Conclusions of the First and Second Report on Adjustment Lending

The First and Second Reports on Adjustment Lending are two recent comprehensive efforts at evaluating Bank experience with adjustment programs (World Bank 1988a and 1990a). We summarize below the main conclusions of these reports.

### The main conclusions of the first report were:

**Success in Improving Performance.** Adjustment lending was moderately successful in improving aggregate economic performance. Despite suffering more serious shocks, the 30 countries that received adjustment loans before 1985 performed better (increased growth more) on average than the 63 that did not. The performance was even better in the 12 countries with three or more adjustment loans before 1987 and in countries that were substantial exporters of manufactured goods. Adjustment lending appeared to have been relatively less successful in the highly indebted countries and in Sub-Saharan Africa. Detailed country studies corroborated the statistical findings. The report cautioned, however, that the conclusions were tentative, because it was difficult to isolate the effects of adjustment lending from the effects of initial conditions and external shocks.

**Implementation of Conditions.** The overall rate of implementation of conditions was good, and conditions were more likely to be implemented when the loan agreement spelled them out precisely. In a sample of about 50 adjustment loans to 15 countries, 60 percent of the conditions were met fully -- during the loan period, and another 24 percent were substantially fulfilled.

**Adequacy of External Financing.** Although the sudden cutoff of external financing made some type of adjustment essential, orderly and sustained adjustment required adequate external financing. In some countries unanticipated underfunding of the program reduced or delayed the benefits. In other instances, however, external adjustment assistance simply delayed the implementation of adjustment measures.

**Commitment to the Reform Program.** The governments that best sustained their commitment to reforms were those that "owned" the program from the start. Although international agencies often assisted in preparing the programs, the governments had to be convinced that the operations were the most appropriate way to address the problems facing their countries.

The Main Conclusions of the Second Report were:

**Aggregate Effects of Structural Reforms.** Countries adopting adjustment programs have on average grown faster than other countries. After adjusting for the effects of initial conditions, external shocks, and the amount of external financing, the countries that entered full-fledged adjustment programs (EIAL, or Early Intensive Adjustment Lending countries) had a larger increase in the average rate of GDP growth than other countries. For some of these countries -- such as Nigeria, the Philippines, Malawi, Cote d'Ivoire, and Mexico -- growth was slower than country characteristics would have predicted. In other countries -- such as Korea, Mauritius, Morocco, Ghana, and Thailand -- programs supported by the Bank appear to have stimulated growth by more than the initial conditions, external shocks, and external financing would have suggested. Constant-price exports as a share of constant-price GDP has increased substantially in the EIAL countries, both before and after adjusting for other factors.

Adjusting for these same factors, investment fell on average as a hare of GDP in the EIAL countries. This means, however, that the relative efficiency of investment in EIAL countries rose, because they achieved higher growth with less investment. Both public and private investment declined. Often a decline in public investment was desirable, since its level was unsustainable and some of it had been misdirected. But for countries that have made major progress in reducing macroeconomic imbalances and reducing distortions and institutional weaknesses, resuming public investment in infrastructure is important for stimulati g private investment and for restoring growth. The reduction of private investment in the initial years of an adjustment program was predictable, because incentives were being changed and the credibility of the program was building. The counterpart of the temporary decline in the investment ratio is that adjusting countries were able to have higher private consumption than otherwise. This should help sustain the reforms.

**Need for a Supportive Macroeconomic Environment.** A stable macroeconomic framework contributes to the success of structural adjustment in every major area of the economy. Adjustment programs were more likely to fail when a stable macroeconomic framework was not in place, even when the adjustment package focused mainly on microeconomic and sectoral policies. So, in a country that starts with high inflation and a large current account deficit, the structural adjustment program should focus initially on measures to reduce inflation and the current account deficit. The macroeconomic situation will be supportive of the adjustment program when the inflation rate is reasonably low and predictable, real interest rates are appropriate, the real exchange rate is competitive and predictable, public sector saving rates are compatible with the resource mobilization requirements of the program, and the balance of payments situation is perceived as viable.

**Effect of Adjustment on Poverty and Living Conditions.** Some short-run social costs are inevitable when an economy has to adjust to adverse external shocks or the effects of previous policy mismanagement. When some of the poor are among the losers from adjustment, they suffer greatly since they were already at a subsistence level. Although the situation of the poor during adjustment offers no cause for complacency, the Report did not find evidence that adjustment lending was associated with an increase in the overall misery of the poor. On the contrary, orderly adjustment, supported by Bank lending, seems to be less costly for most of the poor and for the general populace than disorderly adjustment without Bank support.

Changes in the available socioeconomic indicators of living conditions do not appear to be systematically related to adjustment lending. The rate of growth of private consumption in EIAL countries in 1985-86 increased in total and on a per capita basis, in comparison with other country categories and when controlling for other factors. Current consumption appears to have been protected -- relative to other countries -- by a reduction in investment expenditures. Other short-run indicators, such as nutrition and immunization, have also improved for the EIAL countries. Long-run indicators of living conditions, such as infant and child mortality, have continued to improve in most countries, with or without adjustment lending. However, the poor quality and the aggregate nature of the data do not point to unqualified conclusions on these issues.

While socioeconomic indicators show continued improvement, the share of central government expenditure on the social sector has fallen slightly on average in countries with adjustment lending. Per capita social expenditures by the central governments have also declined in some adjusting countries. It is possible that some of the impact of declines in health and education expenditures on lower income groups were offset by increased contributions from local governments and by better targeting of government spending. The declines in education expenditure have been accompanied by falling primary school enrollment ratios for the EIAL countries. To prevent declines in socioeconomic indicators, most adjusting countries need to increase social sector expenditures targeted toward the poor.

Since adjustment is taking longer in most countries than originally expected, recent adjustment operations supported by the Bank include more detailed analyses of the social impacts of adjustment programs and more measures to alleviate the short-run costs of adjustment to the newly unemployed and the poor. Such measures include reallocations of social expenditures toward services used by the poor, severance payments and retraining for newly unemployed workers, and public works and employment schemes for unskilled workers. In some cases, several targeted interventions have been assembled into multi-sector compensatory programs.

**Raising Efficiency.** Increases in the efficiency of investment can reduce the need for more saving. Distortionary policies, such as trade restrictions and financial repression, hold down the efficiency of investment and thus the rate of growth for a given investment level. Removing these distortionary policies does the reverse: it increases the efficiency of investment and the growth rate of GDP for a given level of investment. Furthermore, analysis indicates that reform efforts must reach a critical mass to be effective: small decreases in extremely high distortions do not have much effect on growth. To have significant payoffs, reform programs usually must focus on large reductions in the large distortions.

**Increasing Investment.** To sustain adjustment and restore growth, countries must not only reduce distortions, they must also create the conditions for an eventual increase in investment. Some countries, especially in Africa, need more domestic saving and external financing to reach investment levels consistent with the restoration of growth. But in many countries, the prevalence of capital flight indicates that stagnant investment results from inadequate demand for investment rather than from the unavailability of saving. In highly indebted countries, the debt overhang often creates uncertainties about the sustainability of the balance of payments situation and about macroeconomic stability, and thus may thwart the recovery of private investment. Debt and debt-service reductions in the context of adjustment programs can help reduce these uncertainties.

The eventual recovery of investment requires an appropriate and credible economic environment. Investment does not respond well when investors, foreign and domestic, doubt that the government will sustain its reforms and when legal and bureaucratic impediments are left untouched. Private investors often wait before making irreversible investment decisions, keeping their assets elsewhere. Providing appropriate public investments that complement private investment, and persuading some private investors to commit themselves, usually helps to overcome the doubts of the majority. But there is no simple way to bring this about. The obvious remedy of specific investment subsidies is likely to be expensive and at odds with the objectives of leaving decisions to market forces and restoring fiscal balance. An appropriate strategy for increasing investment contains four elements:

- Establishing and maintaining macroeconomic stability, including a predictable and competitive real exchange rate, a small budget deficit, and low rates of monetary growth and inflation.
- Removing legal and bureaucratic impediments to investment by domestic and foreign firms, and providing clear rules for taxation, property rights, and the regulation of production and trade.
- Expanding public investment that is complementary to private investment.
- Ensuring sufficient external financing to support a sound program in both the medium and the long terms. In highly indebted middle-income countries committed to sustaining a reform effort, the Brady initiative and other debt-reduction schemes should help improve the viability and credibility of adjustment programs.

**Raising Saving Rates.** To sustain desirable rates of investment and growth, the saving rates in most adjusting countries have to increase, especially in many African countries which started the 1980s with very low saving rates. The most effective way to increase saving in the initial years of an adjustment program is to increase public saving. Private saving, responsive mainly to an increase in the GDP growth rate, starts to increase after growth gets under way. Once real interest rates are positive, further increases of real interest rates on deposits and special tax treatments for savings are unlikely to cause any large increase in saving rates.

**Refinements.** The findings of the second report confirm and extend some of the conclusions of the first report. The sequencing and packaging of reform measures is crucial. In countries that start with high inflation and a large current account deficit, the first step is to implement stabilization measures. Structural reforms aimed at maintaining macroeconomic balance should be emphasized next. Sectoral reforms should be sequenced in a way that takes account of the linkages among sectors. For instance, trade liberalization is likely to improve efficiency more if accompanied by measures that improve the functioning of domestic markets for goods and credit, provide needed infrastructure, and reduce controls on domestic investment and impediments to labor mobility. In some low-income countries, barriers to the integration of the domestic economy -- poor roads, inappropriate domestic transport infrastructure, lack of domestic financial markets, and so on -- are major impediments to economic growth, which should be tackled early.

The data set on conditionality and implementation, with a much expanded sample of loans approved in FY79-88, showed most of the same patterns found in the first Report, and revealed some new ones. Countries begin implementing their structural adjustment program before the adjustment loans become effective and frequently continue implementation after disbursement ends. Progress in implementation is measured by the share of conditions in the loan agreements that have been implemented by the time of final tranche release. Of all conditions in the loan agreements in the sample, 84 percent had been implemented at least substantially -- better than found in the first Report --

and 66 percent had been implemented fully or more than fully by the time of final tranche release.

Implementation rates increased during the 1980s, both for countries that had received adjustment loans since the early 1980s and for countries that started more recently. For the loans in the sample that had final tranche release in FY89, i.e., since the first Report, 99 percent of the conditions were implemented at least substantially, and 80 percent of the conditions as originally written were implemented fully or more. In the rare cases when a condition as originally written does not seem necessary, the Bank waives the condition, with approval from the Board. Not counting the one loan in the sample for which this occurred in FY89, would raise the proportion of fully implemented conditions from 80 to 88 percent. Essentially, the final tranches were released only when all conditions in the loans were at least substantially fulfilled.

The second report also examines political economy factors in the implementation of adjustment programs. Governments have more frequently been able to develop and maintain political support for structural adjustment when the program was designed with the need for political support in mind, and when the government was active in explaining the source of the problems addressed by the program, how it planned to tackle them, why this was the best option and how people would benefit from the new policy environment. Mobilizing beneficiaries to become political supporters usually follows. While technical considerations sometimes cause unavoidable delays in program implementation, more prompt implementation almost always increases the chances of political support. Awareness of the economic problems that motivated the initial decision for reform will be strongest at the beginning, giving the authorities maximum latitude for reform. The support for sustaining the new status quo then develops as structural reform pays off in growth and higher living standards.

A final conclusion of the two Reports is that adjustment programs need to give greater attention to reforming and developing institutions in several areas: the agricultural sector in Sub-Saharan Africa; the financial sector and fiscal management in many countries; and public enterprises in almost all countries. Although adjustment programs often call for a reduction of resources going into the public sector, it is equally important to strengthen public institutions through improved policies, organization, and management. Institutional development is essential for both the implementation and the ultimate success of many of the reforms the Bank supports.

## V. Concluding Remarks

The design and implementation of adjustment programs is not an easy task. Nor is it a task that can be carried out successfully unless each program is tailored to the specific circumstances of the adjusting country. However, some lessons that have found their way into Bank-supported programs have emerged from the analysis of adjustment problems and programs.

In countries that are experiencing acute macroeconomic imbalances manifested in the form of high fiscal deficits, balance of payments crisis and high open or repressed inflation, adjustment should start with policy and institutional reforms to deal with the ultimate causes of the macroeconomic crisis. Once enough progress has been achieved in reducing inflation and the fiscal and balance of payments deficits, other structural reforms aimed at improving resource allocation and achieving sustainable and equitable growth should be attempted. Among the latter reforms the most common are: public sector reforms, trade/domestic competition reforms and financial sector reforms. Labor market reforms, although attempts in many cases, are not as common as they should be.

The Bank can assist the adjustment process by providing both finance and policy advice. Furthermore, the Bank helps countries in mobilizing other sources of finance. What impact has Bank adjustment lending had on borrowing countries? It was found in RAL-2 that, adjusting for non-program factors, adjustment lending has had a positive effect on growth, and on the constant price export and investment rates. However, it has had a negative effect on the investment ratio.

With respect to the effects of adjustment lending on social indicators, the available evidence shows that changes in living conditions in the short run do not appear to be systematically related to the presence or not of adjustment lending.

The implementation rate of programs increased during the 1980s, both for countries that had received adjustment loans since the early 1980s and for countries that started more recently. However, implementation rates are lower for countries with higher rates of inflation and for countries that suffered higher negative external shocks. Successful stabilization and appropriate adjustment to external shocks (including contingency financing) help to increase the implementation rate of programs.

Both RAL-1 and RAL-2 underline the importance of a good diagnosis of the development problems facing a country, and of the need to build a consensus around the adjustment program. External financing can help the implementation of a government owned program, but it will not be effective if the government is not convinced of the need for adjustment. To be successful, a program has to be owned by the government.

Governments have been more frequently able to develop and maintain political support for structural adjustment when the program was designed with this aim in mind and when the government was active in explaining the source of the problems addressed by the program, how it planned to tackle them, why this was the best option, and how people would benefit from the new policy environment. Mobilizing beneficiaries to become political supporters usually follows. While technical considerations sometimes cause unavoidable delays in program implementation, more prompt implementation almost always increases the chances of political support. Awareness of the economic problems that motivated the initial decision for reform will be strongest at the beginning, giving the authorities maximum latitude for reform. The support for sustaining the new status quo then develops as structural reform pays off in growth and higher living standards.

Although adjustment programs often call for a net reduction of resources going into the public sector, it is equally important to strengthen public institutions through improved policies, organization, and management. Institutional development is essential for both the implementation and the ultimate success of many of the reforms the Bank supports.

The ultimate success of the adjustment programs depends not only on getting the right policies in place but also on increasing investment -- including efficient public investment, saving and growth. Public policy has much to contribute to these objectives by mobilizing saving and providing a macroeconomic framework in support of investment and efficient growth.

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